

Top of Mind

May 16, 2013

Issue 12

The Ins and Outs of the EU/EMU

From the editor: Another crisis in the Euro area periphery (Cyprus), an unsettling election in Italy, and a pledge for a UK referendum on European Union (EU) membership have pushed the question of what the EU/Economic Monetary Union (EMU) will ultimately look like to Top of Mind. We ask two experts: former ECB executive board member Lorenzo Bini Smaghi, who believes that any exit would be irrational and is an admitted long-term optimist on the EU/EMU (but a near-term pessimist), and Professor Hans-Werner Sinn who advocates allowing countries to temporarily exit and devalue to address “desperate” situations. We look at the incentives for peripheral economies to remain in despite this pain, but recognize that whether they end up in or out may not be up to them. We conclude that Italians remain devoted to the EU/euro (more so than their own institutions), but the reverse for the UK, and discuss why countries still want to join.



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Inside

Interview with Lorenzo Bini Smaghi	4
Former member of ECB executive board	
Italy and Europe: a 50 year marriage	6
Silvia Ardagna, GS Markets Strategy	
Interview with Hans-Werner Sinn	8
President, Ifo Institute	
Will the periphery survive in the euro?	10
Huw Pill, GS European Economics Research Themos Fiotakis, GS Markets Strategy	
UK in or out?	12
Kevin Daly, GS European Economics Research	
Why join?	14
Magdalena Polan, CEEMEA Economics Research	



Transformations [of the periphery] will be costly in terms of economic growth and employment. But they would be required – and would be costly – whether the country was inside or outside the Euro area.”

Huw Pill and Themis Fiotakis, GS



Since the start of the crisis, I have maintained that no country would leave. One cannot exclude the potential for irrational decisions to lead to exit. But there is no rational incentive, especially now that some of the cures are starting to work.”

Lorenzo Bini Smaghi, former ECB



The solution is either inflating the core of the Euro area to make the periphery competitive or, if the core does not want that... then it would be better for countries...to exit the EMU, devalue and possibly return after some years.”

Hans-Werner Sinn, Ifo Institute

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Macro news and views

We provide a brief snapshot on the most important economies for the global markets

US

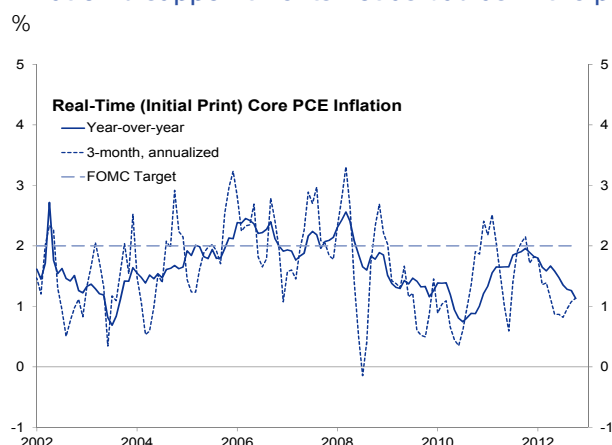
Latest GS proprietary datapoints/major changes in views

- No changes in view. Our US Current Activity Indicator (CAI) for April was a tepid 1.3%. We maintain that the fiscal drag and weakness in Europe and Asia will keep growth soft in the near term before a pick-up in 2014 as the fiscal drag abates.

Datapoints/trends we're focused on

- A larger-than-expected decline in inflation; a further meaningful drop could trigger renewed Fed easing.
- Declines in labor participation that have generated much of the decline in the unemployment rate; the Fed may need to re-think using the unemployment rate as a catch-all indicator of labor market conditions.

Inflation disappointments not as bad as in the past



Source: Federal Reserve Bank of St. Louis, Goldman Sachs Global ECS Research.

Japan

Latest GS proprietary datapoints/major changes in views

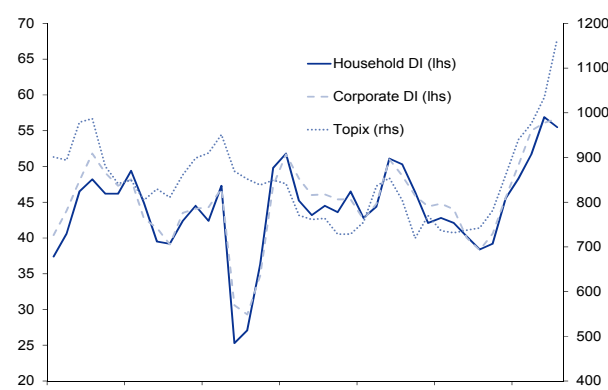
- We maintain that a weaker Yen, stronger equity market and fiscal/monetary stimulus will improve growth in 2H13 and 2014.

Datapoints/trends we're focused on

- Much stronger-than-expected 1Q13 GDP at 3.5% qoq ann.
- Improvement in sentiment indicators, which bodes well for further improvement in the real economy; we expect 2Q GDP to again be 3%+ qoq ann. partly due to robust consumer spending.
- Additional easing pressure as expectations of making progress towards inflation goals rise, likely by October.

Sentiment on the rise

Diffusion Index (DI) (lhs); Topix index (rhs)



Source: Cabinet Office, TSE.

Euro area

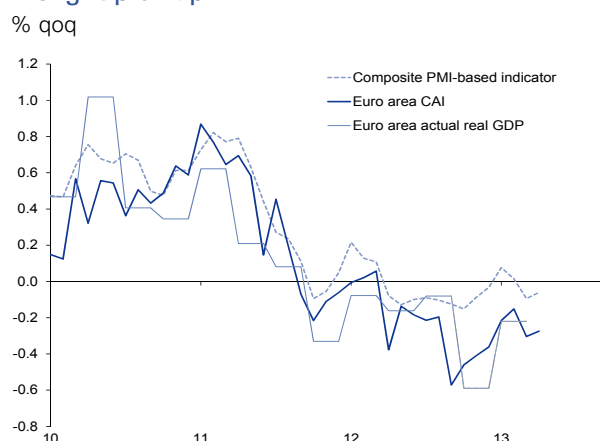
Latest GS proprietary datapoints/major changes in views

- We revised down our growth forecast for 2013 in late April owing to weaker-than-expected growth in 1H13 (we now expect -0.7% growth in 2013) but expect growth to pick up in 2H13.

Datapoints/trends we're focused on

- A negative surprise in 1Q13 GDP for the largest EMU economies relative to consensus.
- A modest recent improvement in Euro-area momentum, consistent with our forecasts for a small growth pick up in 2H13.

A slight pick-up



Source: Eurostat, Markit, Goldman Sachs Global ECS Research.

Emerging markets (EM)

Latest GS proprietary datapoints/major changes in views

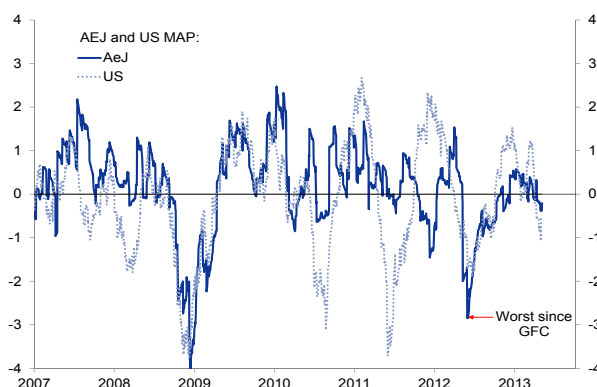
- Asia ex-Japan MAP scores (track the direction and extent of "surprise" in data releases) have turned negative; regional data disappointments in 2012 were the worst since the GFC.

Datapoints/trends we're focused on

- Another slight disappointment in Chinese activity indicators in April despite a relatively loose monetary and fiscal policy stance in recent months; we expect growth to pick-up in coming months alongside improving external demand.

AeJ 2012 disappointments largest since GFC

MAP scores (positive values = positive surprises rel. to Bbg cons.)



Source: Bloomberg, Goldman Sachs Global ECS Research.

The Ins and Outs of the EU/EMU

Another crisis in the Euro area periphery (Cyprus), an unsettling election in Italy, and a pledge by British political leadership for a referendum on the UK's membership of the European Union (EU) have pushed the question of what the Euro area and even the EU will ultimately look like post the current period of transformation (who will be in and who will be out?) to Top of Mind.

We ask former ECB board member Lorenzo Bini Smaghi if any country would be better off exiting the euro (no), what else the ECB should be doing to help make the Economic Monetary Union (EMU) work (not much because this responsibility lies primarily with national authorities, but a weaker euro would help), if UK exit would matter to the EU (not as much as in the past; there is less willingness today to keep the UK in the EU at all costs), and if the new Italian government will be able to implement structural reforms that would help ensure Italy's survivability in the Euro area (unclear because you need a government that has a lot of support and longevity to pull this off, but Italy euro exit is extremely unlikely). Silvia Ardagna of our markets team agrees in "Italy and Europe: A 50 year marriage", asserting that the Italian population has more trust in the EMU/EU than in their own political establishment – their largest source of frustration – and therefore will likely remain devoted to the euro.

We then talk to noted German economist Hans-Werner Sinn, who takes a different view on the best path for the EMU. According to Sinn, the EMU's institutional set-up should allow more flexibility around the edges so that countries that lose competitiveness can temporarily exit, devalue, and (hopefully) rejoin the euro at a later stage. We ask him which countries should exit (it is up to the countries, but the situation for the Greek population is particularly desperate) and what more, if anything, should Germany do (they have already done too much; pressure for austerity is not coming

from Germany, but from the markets; by footing much of the bill for the Euro area assistance programs, no country has mitigated austerity as much as Germany has.)

GS Chief European Economist Huw Pill and Themis Fiotakis of our markets team take a look at the obstacles facing the most vulnerable periphery countries in "Will the periphery survive in the euro?" Their answer is largely yes, but it will require that populations endure very high unemployment for a prolonged period and that adjustments in the periphery are sufficient to continue to motivate core countries and official lenders to provide the subsidized loans that these countries desperately need. This seems very doable for Greece, but somewhat less so for Cyprus.

GS UK Economist Kevin Daly then focuses on the broader EU picture and the UK's future role in it in "UK in or out?" He concludes that a UK exit from the EU would be a "loss/loss" situation for the UK and EU, but for all of the hype on the potential referendum, it's actually unlikely to happen at all.

Lastly, amid all of the Euro area trauma in recent years, our CEEMA Economist Magdalena Polan asks why countries are still lining up to join the EU and even the EMU in "Why join?" For the smaller countries, the answer boils down to the fact that they are largely already pegged to the euro and substantially impacted by EU/EMU decisions, but have no say in them. For larger countries (like Poland) the answer becomes all the more complicated.

Allison Nathan, Editor

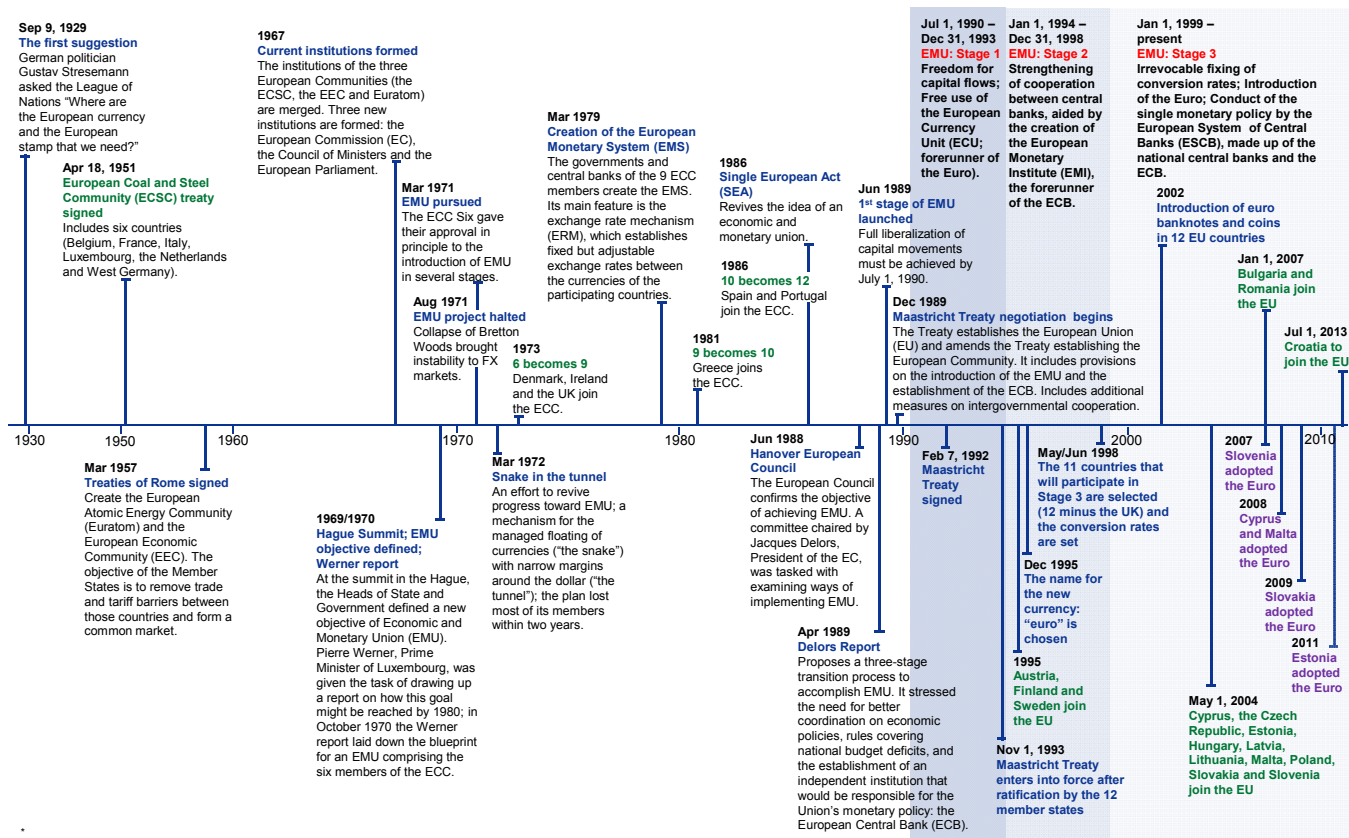
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The history of the EU/EMU



Source: European Central Bank, Europa, Goldman Sachs Global ECS Research.

Interview with Lorenzo Bini Smaghi

Lorenzo Bini Smaghi is a former member of the executive board of the European Central Bank (ECB) and currently a visiting scholar at Harvard's Weatherhead Center for International Affairs and at the Istituto Affari Internazionali in Rome. Below he shares his views that no country will rationally exit the euro area, but that the next five years will be difficult ones for the EMU.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: What challenges does the disparity in economic conditions across the Euro area pose for the ECB?

Lorenzo Bini Smaghi: The ECB is used to having different underlying economic conditions. Even in the past, cyclical conditions were never fully convergent. However, right now you have the additional complication that not only are

cyclical positions different, but also the way in which monetary policy works through the system, the so called "transmission mechanism" of monetary policy is very different. So, the impact of an interest rate cut, for example, is much smaller on those countries that need it the most. This is because the key to transmission is the stability of the banking system, which borrows funds from the ECB and then lends them to households and firms. If the banking system is not stable, then interest rate cuts do not flow through to those who need credit in a proportional way.

Allison Nathan: What should the ECB be doing to help make the EMU work?

Lorenzo Bini Smaghi: Given that the problem is in the transmission mechanism and this transmission depends on the structure of the banking system and on the public finances of each country, **the solution is largely the responsibility of national authorities and not so much the ECB.** When the ECB takes responsibility for supervision, it will play a larger role. But in the current circumstances there are limits to the action that the ECB can implement. It has already made access to refinancing unlimited subject to collateral and has recently cut a key interest rate. Of course, there are other things that can be done at the margin, like enlarging the pool of collateral that banks can use to borrow ECB funds. But again, if the banks have problems of solvency and credibility that limit their access to the markets, these problems will not be solved through monetary policy measures.

Allison Nathan: If you were ECB Governor Mario Draghi, would you do anything differently?

Lorenzo Bini Smaghi: **I would try to weaken the euro.** Exchange rates are an important element in the transmission of monetary policy so a weaker euro would certainly help. The Euro area is in a worse cyclical position than its main trading partners and therefore should have the weaker currency. But, achieving a weaker euro is not easy because all of the central banks are trying to weaken their home currency, starting with the Bank of Japan.

Allison Nathan: Should the ECB pursue quantitative easing (QE) (central bank asset purchases, mostly of domestic bonds, to keep long-dated interest rates low) like the US and Japan?

Lorenzo Bini Smaghi: QE in Europe would likely entail the ECB purchasing a representative basket of Euro area government bonds. And so they would probably have to buy large quantities of German and French bonds, rather than the bonds of countries that

could use more support; **the impact on spreads would not necessarily be in the right direction.** So from a technical point of view, the case for QE in Europe is less clear cut.

Allison Nathan: Was the ECB's Outright Monetary Transactions (OMT) program (allows the ECB to buy Euro area government bonds of struggling countries) the right one?

Lorenzo Bini Smaghi: Yes. The downside is that it has reduced pressure on the political authorities to implement reforms and consolidation. This is an unintended consequence of all sorts of central bank measures in the US, Japan, and also in Europe. **But I don't think the program was a mistake.** The mistake was on the part of the governments. I think the OMT was needed to reduce the catastrophic risk that was in the mind of investors after Greece restructured its debt. Central banks have a difficult balancing act to make. They have to keep the pressure on governments to continue reforms but they also have to do what they can to avoid the huge risks of collapse of the system. Should that happen, it would be nearly impossible for governments to act to improve the situation.

Allison Nathan: European authorities talk about the need for financial and banking union, fiscal union and political union to make the euro work. How do you rate the progress on these?

Lorenzo Bini Smaghi: On the banking union we have made important steps. We have a broad agreement on the single supervisor and just need to finalize it. The ECB should be acting in this capacity by Spring of 2014. There are also concrete proposals on the single resolution regime. I am confident that banking union will happen, and this will be very important in eliminating the segmentation in financial markets and restoring confidence between banks, which will be key to reviving economic growth.

The fiscal union is much more complicated because it really strikes at the heart of national sovereignty, and to move it to a European level requires changes in the political infrastructure - a move towards political union. So, moving to fiscal union and political union are closely linked and will likely require treaty changes, which will take more time. It's therefore more difficult to see intermediate steps as you have with banking union. But the creation of the European Stability Mechanism (ESM) (permanent rescue funding program for EU states) and the fiscal compact are already important moves forward. Europe doesn't move necessarily by huge jumps, but rather by small steps.

Allison Nathan: Should Italian policymakers have done anything differently post the Global Financial Crisis (GFC)?

Lorenzo Bini Smaghi: Yes. In Italy they have systematically tackled the symptoms of the problems rather than the cause of the problems, the symptoms being high debt and high deficits. They try to fix the symptoms most often by increasing taxes and sometimes by cutting expenditures. But the real problems of the Italian economy are low growth, low productivity, inefficient public sector administration, an uncertain judicial system, and lack of competitiveness in the labor market. These structural reforms have been continuously postponed due to the opposition of powerful

lobbies and interest groups. For this reason, economic growth in Italy even before the crisis was low relative to other European countries, which makes the current austerity that much more painful; Italy is second only to Greece in terms of the GDP loss during the current recession, and consumption and income have retreated to levels not seen since before the start of the euro. Focusing on the symptoms rather than the causes ultimately leads to more austerity and potentially self-defeating adjustments.

Allison Nathan: Can the new Italian government implement the structural reforms necessary to stimulate growth and ensure sustainability in the euro area?

Lorenzo Bini Smaghi: In order to make structural reforms you need a very strong government with a long horizon. And it is not clear yet how strong the new government is in terms of support of the parties that are behind it and how long will it last. They have started out addressing very short-term issues with, again, an unfortunate focus on the symptoms rather than on the causes. So **the initial signs are not that encouraging.**

Allison Nathan: How much of a threat to Italy's adoption of the euro is the rise of populism in Italian politics?

Lorenzo Bini Smaghi: The rise of populism in Italy is mainly due to frustration over having to deal with the same politicians for 20 years rather than an anti-euro or anti-Europe sentiment. This frustration over no change in the political scene led to the creation of the anti-establishment 5 Star Movement that dominated the parliamentary elections. Of course, some dissatisfaction is also linked to the austerity program and the fact that Europe is seen more as a policeman than somebody who helps. But I don't believe that these are the main drivers of the rise in populism so in that sense I do not believe that Italy's adoption of the euro is at risk.

Allison Nathan: Do you think there's any chance that Italy will exit the euro?

Lorenzo Bini Smaghi: No. I think the choice for the people is whether they want their bank accounts denominated in euro or in a new lira. And **I think ultimately, most people will want their savings to be in euro.** Going back to the lira would not really help in a sustainable way. It might create room for some short-term improvement in competitiveness, but that will not be lasting, as the experience of the past has shown. In the 1970s and '80s the lira devalued systematically but the gains in competitiveness were very short lived. Italy spent too much time and energy competing in low value-added manufacturing sectors that relied on a weaker currency instead of trying to improve competitiveness through investments and technological change. And this is what made Italy more fragile when globalization occurred.

Allison Nathan: Would any country be better off exiting the euro?

Lorenzo Bini Smaghi: **No.** Even Greece, which was very close, ultimately realized that outside of the euro it would not have had a better environment to implement the reforms and the changes that it needs to undertake. The cost would be very high and the benefit would be uncertain. Exiting from the euro is not devaluing; it's changing the currency. And it's not clear that the structure of the economy would improve as a result. Part of it might actually remain linked to the euro in some form or another, or indexed to the euro like in many Balkan countries, which basically have a bi-monetary system. For instance, the private sector would probably continue to use the euro to protect itself against inflation and against strong depreciation. And the new currency would be used mainly for official transactions and to try to inflate away the debt.

Since the start of the crisis, I have maintained that no country would leave. Cost/benefit analyses are always based on rational attitudes and one cannot exclude the potential for irrational decisions to lead to exit, especially if another crisis occurs. But **there is no rational incentive for exit, especially now that some of the cures are starting to work.** If you look at Ireland, Portugal, or even Greece, there is some stabilization. And most forecasts foresee further improvement. Now that the pain has been taken, totally changing course only to take on the additional pain of exiting the euro would be irrational.

Allison Nathan: Is the devotion to the euro overdone, like the (destructive) devotion to the gold standard in the 1930's?

Lorenzo Bini Smaghi: No. And it's a very different situation. The gold standard was just a currency peg; countries always had the choice of devaluing. It was only a question of cost and benefits of a policy change, which could happen in a few minutes. In the case of the euro, if you change the currency, it's a huge endeavor, which would affect the behavior of millions of people who would be expected to use the new currency. But they would have a choice, of course, unless you constrain them, of continuing to use the old one. And as I said, most of the economy would try to avoid being penalized by the currency move, i.e. being forced to take a loss by converting to a currency that is worth less. The risk of capital losses would occur for the banking system, for all the creditors and probably also the debtors that could not change their contracts because their contracts are denominated in euro. They would not be able to repay it. The impact would be huge. So, we cannot compare it to a gold standard regime or some other form of exchange rate adjustment.

Given the complexity of a potential euro exit – let alone the collapse of the euro itself, which would be a nightmare and result in lawsuits, redistribution of wealth from various sectors, defaults, etc. – a very strong devotion is appropriate. If anything devotion has waned a bit as reflected in all the polls, but the popularity of national governments and institutions have waned even further. So, **it's the general effect of a very difficult situation that the trust in public institutions is low and declining.**

Allison Nathan: Will the single currency last?

Lorenzo Bini Smaghi: I think it will last. It's going to be a long and painful adjustment in many countries, but I think it will last and may even increase given that some countries will likely join.

Allison Nathan: Will the UK remain in the EU and does it matter to the EU either way?

Lorenzo Bini Smaghi: I think a UK exit from the EU would be an economic and political loss for Europe given that London remains the most important financial center in Europe and is a strong promoter of competition and of the single market. But I think most other Europeans would say that we knew from the start that Europe is a project and has to move forward and those who don't feel the same way ultimately become an obstacle. **There is less of a willingness to retain the UK at all costs** compared to the past.

Allison Nathan: What do you think Europe will look like in 5 years' time? 15 years?

Lorenzo Bini Smaghi: In 15 years I'm a bit more confident because I think the adjustments will have been made. Europe will become more competitive and stronger. So **I am a long-term optimist. But I am also a short-term pessimist;** the near-term adjustment is maybe a bit too tough and too front-loaded so the next five years are going to be very difficult.



Italy and Europe: a 50 year marriage

Silvia Ardagna of GS markets strategy underscores the desire of Italians for efficient institutions, at home and for the EU/EMU

The results of the Italian general elections spurred worries about the commitment of the Italian population to the Euro area. During the electoral campaign, the 5 Star Movement was vocal against fiscal austerity and called for a referendum on the euro. And they ended up as the strongest single party in Parliament. But, the 5 Star Movement also campaigned against the corruption of the political establishment, waste of the public administration, tax evasion and, generally speaking, the inability of the existing political, bureaucratic and justice system to run a well-functioning, efficient democratic state. Whether the victory of the 5 Star Movement signals the build-up of an anti-Euro sentiment that undermines Italy's participation in the EMU or a protest vote against the political establishment is hard to prove. But we believe that the latter is more likely and that the majority of Italians remain committed to the single currency.

Italy: The "Founding father"

In 1957, the Treaty that established the European Economic Community (EEC) was signed in Rome and since then, **as a "founding father", Italy has been a strong supporter of the European project including the single currency.** When the Maastricht Treaty was signed in 1992, Italy faced a tough adjustment to qualify as a member of the currency union. But, adopting the euro at inception was a matter of national pride. It was also the way through which economists believed that Italy could achieve lower inflation and embark on more virtuous fiscal and economic policies via the adoption of more credible European institutions that would rein in national policymakers.

From 1993 to 1999, despite the difficult fiscal adjustment required to join the EMU and the fact that Italian companies could no longer rely on exchange rate devaluations to gain competitiveness, Italy remained by far the strongest supporter of the single currency.

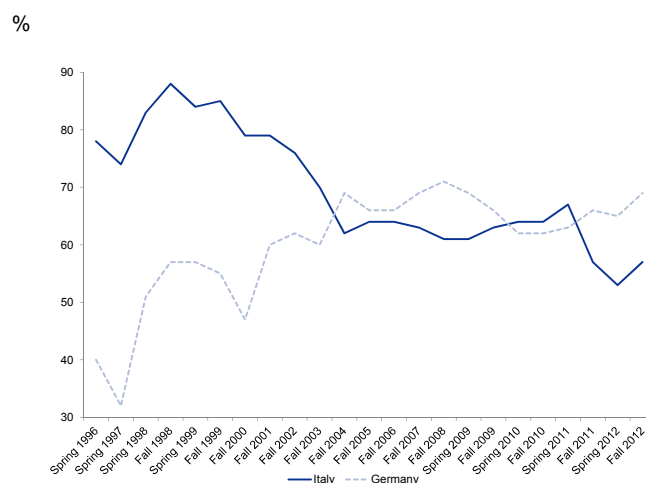
Approval rates for the euro were about 30%-40% higher than in Germany. Since the currency was introduced in 1999, support declined to the average of the approval rate among countries that adopted the single currency. It strengthened during the global financial crisis until the fall of 2011. But Italian support for the single currency fell sharply to 53% in the spring of 2012 and has only recovered modestly since then¹.

What led to the sharp pull-back?

From the fall of 2011 to the spring of 2012, Italy undertook a sharp fiscal adjustment. Contrary to what happened during the run-up to the euro, financial markets did not react positively to the measures that were implemented. Higher yields and, effectively higher borrowing costs for firms and households, fuelled a strong credit crunch and the economy entered a sharp recession. Italian politicians and media were repeatedly advocating for help from Europe to 'fight the irrational behavior' of financial markets. Help materialized only in July 2012 when ECB President Draghi committed to do 'whatever it takes' to protect the euro, and subsequently announced the Outright Monetary Transactions (OMT) program, which would allow the ECB to buy the debt of

struggling countries as long as they met certain conditions. Since then, the Italian approval rate for the euro has increased even though the economy has remained weak. **The decline in the single currency's approval rate therefore had more to do with temporary discontent about the lack of support from the ECB, in our view, than with the general pressures for austerity and reform coming from the EMU.**

Italy a euro champion, historically



Note: The chart shows the percentage of interviewees replying in favor to the following question: "Are you in favor or against a European economic and monetary union with one single currency, the euro?"

Source: European Commission: "Eurobarometer Survey", various issues.

In European institutions we trust

Italian households continue to trust European institutions more than their own government. When asked whether Italy needs reforms to face the future, 88% of Italians interviewed by the Eurobarometer survey answered "totally agree" and 84% believe that more cooperation among Euro area governments is needed to solve the crisis. Also, when asked whether measures to reduce the public deficit and debt cannot be delayed 80% answered "totally agree", and when asked whether measures to reduce the public deficit and debt were not a priority for now the majority disagreed. The economic situation of course affects the perception of the costs and benefits of Italy's participation in the euro. But as long as trust in European institutions is greater than trust in national ones, and European institutions are seen as a way to enforce better policymaking at home, **Europe has little to fear from Italy's leaving the currency block.** Therefore, we believe Italians will want to remain part of the EMU, not just of the EU.

A cynic might therefore conclude that the inefficiency of the Italian political system is a guarantee for the EMU. Instead, a strong believer in the European project might warn European policymakers to avoid the temptation of replicating the inadequacies of the Italian political establishment. Sadly, observing the process of reforming the Euro area architecture one cannot rule this out. The challenge for EMU architects is to indeed create an efficient state that Italians (and all other Europeans) are craving.

Silvia Ardagna, Senior Markets Strategist

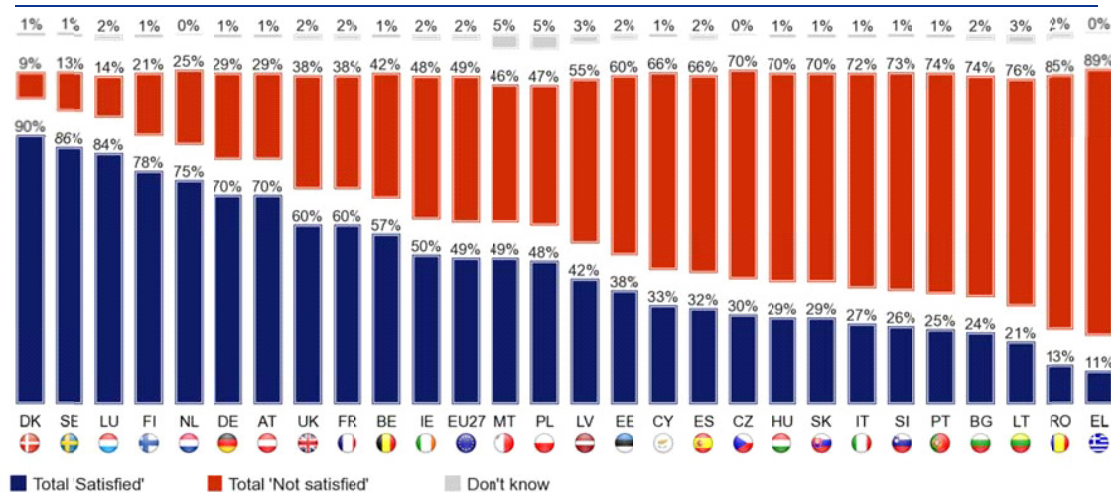
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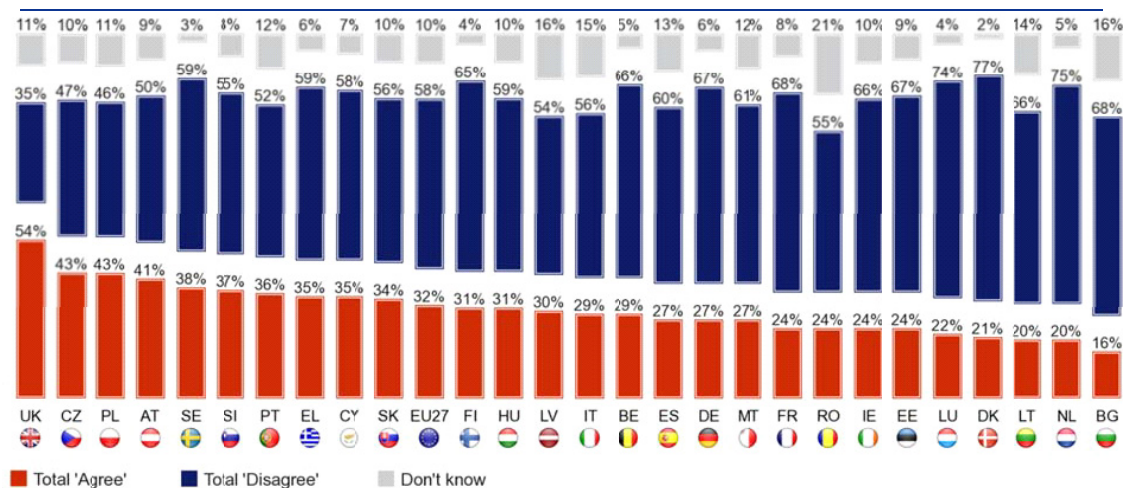
¹ The Eurobarometer survey is a survey conducted since 1973 twice a year by the European Commission among households living in all countries of the European Union.

Survey says...

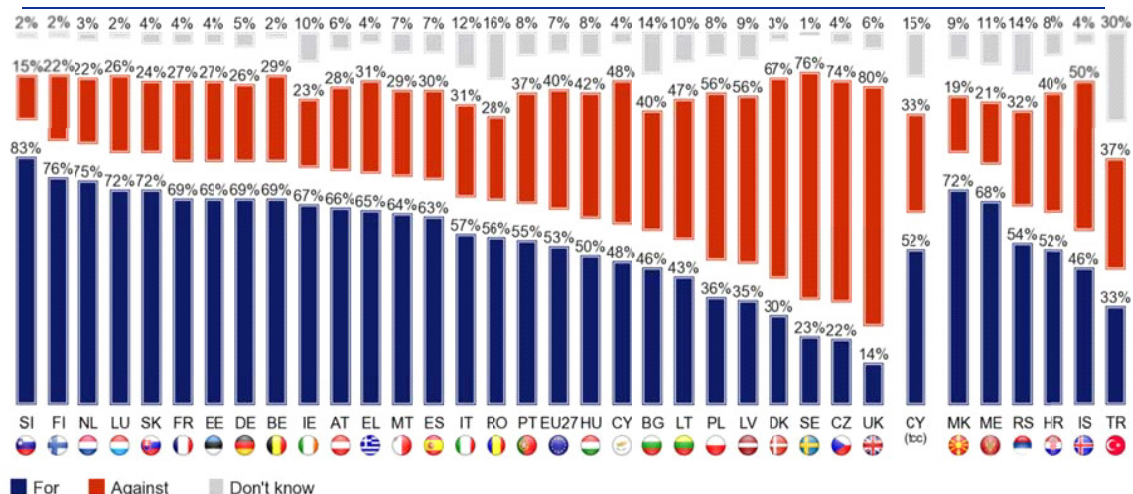
On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy works in (OUR COUNTRY)?



Please tell me to what extent you agree or disagree with the following statement: (OUR COUNTRY) could better face the future outside the EU



What is your opinion on the following statement? Please tell me whether you are for it or against it: A European economic and monetary union with one single currency, the euro



Source: European Commission, Standard Eurobarometer 78, Autumn 2012.

Interview with Hans-Werner Sinn

Hans-Werner Sinn is President of the Ifo Institute and Professor of Economics and Public Finance at the University of Munich. He has published on numerous topics pertaining to the German economy and the Euro area crisis, among other topics. Below he shares his vision for a more flexible Euro area that allows struggling Euro area countries to temporarily exit and devalue.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: Is the EMU sustainable in its current form?

Hans Werner Sinn: I don't think so. Some countries are way out of line in terms of their competitiveness. In the early years of the euro, the euro project itself emboldened investors to flock to Southern Europe for only slightly higher interest rates. In Greece and Portugal, the government borrowed to pay higher wages;

in Ireland and Spain, it was the private sector which borrowed to buy real estate, fueling a construction boom and a real estate bubble. In the end, these economies were inflated through the cheap credit from abroad. The credit-financed wage increases went far beyond productivity increases and deprived these countries of their competitiveness. That seemed possible as long as private credit continued to finance the spending. But when the American crisis swept over to Europe in 2007/08, all of a sudden this turned out to be a problem, because investors began shying away from the Southern countries. Private credit had to be replaced initially by the printing press and ultimately by the open rescue operations of the Euro area governments. The Euro area taxpayers have ended up footing the bill for both kinds of funding.

For these countries to return to health within the EMU, they must reduce their prices to the competitive level. But that path is rather steep. It is estimated that some countries would require a real devaluation of 20% relative to the Euro area average. For others, it is more in the range of 30%. That would be very difficult to achieve, because prices tend to be sticky downwards for various reasons: the unions would likely object, and because of high debt levels, a cut in prices and wages would likely drive many households as well as firms into bankruptcy.

Allison Nathan: What would make the EMU sustainable?

Hans Werner Sinn: The solution is either inflating the core of the Euro area to make the periphery competitive or, if the core does not want that or if the ECB does not succeed in doing so or is legally constrained to do so, then it would be better for countries whose path towards competitiveness is too long to exit the EMU, devalue and possibly return to the Euro area after some years at the new exchange rate. Wishful thinkers see Keynesian deficit spending as a solution, but that would just be a painkiller that slows down or prevents the realignment of relative prices, while it exacerbates the debt problem. Given the catastrophic development of unemployment rates in the Euro area, **I suggest a two-tier Europe in which countries with competitiveness problems have the option to temporarily exit and devalue.** Such a system provides more flexibility at the edges and would allow countries to realign their effective price levels in an orderly way, rather than through catastrophic unemployment. I insist that these exits should be orderly, with the other Euro area countries helping the exiting countries with critical imports and with stabilizing the banking sector. And the ECB should help carry out a pegged floating strategy that avoids extreme exchange rate volatility. Once the

exiting country has regained its competitiveness and undertaken the necessary reforms, it would have the option to return to the first tier and re-adopt the euro. The current situation for some populations is desperate inside the euro. I think we have no choice but to look for alternative solutions such as this one.

Allison Nathan: What kind of disruption would such exits present to the Euro area as a whole?

Hans Werner Sinn: Of course, before an announced or expected exit, turbulences of the Cyprus type would occur, accompanied by capital flight out of the exiting country. So, if you can't manage to pull off the exit and adoption of the new local currency over a weekend, capital controls as in Cyprus would be required. To facilitate the process and further reduce capital flight I would give the existing euro bank notes in the country to the people who hold them. Thus, new domestic bank notes can be printed later and gradually replace the euros. Once the exit has taken place you can immediately lift the capital controls. I don't want to say that there would be no problems. **There would be problems. But I find them minor relative to the other problems that arise if we continue along the current path, which will lead to a clash between taxpayer rescue fatigue and the southern populations' austerity fatigue.**

Allison Nathan: Which countries do you think should exit?

Hans Werner Sinn: That is up to the countries themselves, but **Greece** clearly has a huge competitiveness problem and, with youth unemployment at 70% and total unemployment at nearly 30%, it will obviously have difficulties surviving in the Euro area. You can of course provide the country with further public credit; it has already received the equivalent of 160% of its GDP and is about to receive another 30%. But that does not create jobs. It just ensures that people will not have to starve despite the high rate of unemployment. **Cyprus** is also vulnerable. And **Spain and Portugal** are potentially also at risk.

Allison Nathan: Is exit the only solution? Would structural reforms enable a workable EMU in its current makeup?

Hans Werner Sinn: All reforms in the respective countries, be it labor market reforms, infrastructure improvements, productivity increases, etc., have to lead in the end to real devaluation if they want to be successful. Something like an open devaluation has to be mimicked inside the Euro area through a process of differential inflation or even deflation, and this requires austerity. **But austerity has its limits because, as I already mentioned, prices are sticky downwards.** You can squeeze countries a lot and the prices will not actually come down. After almost six years of crisis, the process of realignment of goods prices has not yet taken place, with one exception: Ireland. Ireland has cut its prices relative to the rest of the Euro area by 15% from 2006 until now. Why? Because they underwent a very, very harsh austerity program given that no one was willing to help them in the first two years of their crisis. All of the other troubled countries came into their crises simultaneously after Lehman; Ireland came into the crisis two years before. After Lehman, the crisis countries were able to find a

majority in the ECB council that would allow them to alleviate their pain by printing the money they could not lend; before Lehman there was no one alleviating the pain. So Ireland had to help itself and it worked its way out of its biggest problems. So that tells us that austerity is a possibility, within limits, but it is very painful, and for some countries too painful, in my view. If a country has strong unions that are well organized, unlike in Ireland, the resistance to wage cuts is much stronger. Also, the path towards equilibrium will be much longer for some countries than it was for Ireland. Ireland had a much lower current account deficit before the crisis than, say, Portugal and Greece. So even with Irish-type austerity programs they would not be competitive.

Allison Nathan: There are rising concerns about even “core” economies in the EMU, such as France. Can France make the necessary adjustments to be successful within the Euro area?

Hans Werner Sinn: It is estimated that France needs a real devaluation of 20% relative to the average of the Euro area. That is quite a bit, but it is manageable. It is on the order of magnitude of the devaluation Germany carried out from the time the euro was announced in 1995 at the Madrid Summit until Lehman. A decade ago Germany was the sick man of Europe, struggling under its own euro crisis, which outside Germany was hardly noticed. The pressure on policymakers became sufficient to push through wage restraint that was large enough to ultimately restore the economy to health. It was not popular with the German Left at all, but only a left-wing politician – Chancellor Schroeder – could do it. Still, he lost his job over his reforms. Today he is hailed as a hero. Everyone now acknowledges that these reforms were right. So **I think the French situation is not hopeless.** France can regain competitiveness with German-type reforms, but not with the kind of policies that the French Left has just declared in a pamphlet, through growth measures by which they just mean Keynesian deficit spending. Those measures would be counterproductive. They are painkillers that help for the moment but prevent the structural adjustments in relative prices from being undertaken.

Allison Nathan: What will force France to embrace reforms, especially given that markets have been very forgiving?

Hans Werner Sinn: More economic pain.

Allison Nathan: Has the OMT program done more harm than good?

Hans Werner Sinn: It has helped the investors. **It has calmed the financial markets. But it should have alarmed the taxpayers of Europe.** Basically the ECB has said to investors: “Don’t be afraid. Before a country goes bust I will buy the government bonds out of your portfolios and put the losses on my books at the expense of Europe’s taxpayers, since they will have to compensate for the decline in our distribution of profits to their respective treasuries.” This is a redistributive measure of dubious value. In my opinion, calming financial markets cannot be the ultimate goal of public policy because, after all, capitalism lives from the uncertainty that makes investors cautious. The sleepless nights investors spend in optimizing their portfolios by avoiding risks and investing prudently is the driving force of capitalism, and if you help investors sleep well by giving them taxpayer guarantees, they will be pleased, but it will not necessarily improve the allocation of resources.

This is just a deferment of the problems and not a real solution. Calming the markets is not the same as stabilizing the real economies. **Market-calming actions actually conflict with real stabilization.** First, if you calm the markets you keep the asset prices above their equilibrium. The result is that private investors

will not come to, and even shy away from, the country in question because they will be afraid that market prices might return to equilibrium, in which case they will lose money. Second, by alleviating the pain of austerity, you keep wages and prices above their market clearing level and preserve the structural current account deficits affecting these countries. And third, calming the markets leads to a revaluation of the euro, which undermines the competitiveness of the crisis countries even further.

Allison Nathan: Could a Eurobond that would mutualize debt across the Euro area be part of a solution?

Hans Werner Sinn: No. I remind you of the early years of the United States of America, when Alexander Hamilton mutualized the American states’ debt, believing this would cement the union. But in fact a few decades later this mutualization turned into a catastrophe, because the states – expecting the debt to be again mutualized – borrowed excessively; a credit bubble developed that burst in 1837, driving most of the American states into bankruptcy. What Hamilton called cement was in fact an explosive.

And the establishment of debt-sharing through Eurobonds would require another treaty. Eurobonds are strictly ruled out by Article 125 of the Maastricht Treaty, which states that the Euro area is not a mutual insurance operation between countries but just an area with a common unit of account for international transactions, where if a country over-borrows it has to go bust and the solution has to be found in bail-ins at the expense of the country’s lenders.

Allison Nathan: How difficult would it be to change the treaty?

Hans Werner Sinn: It would require a complicated ratification process by the parliaments of all member countries, and such ratification would need to be unanimous. Previous treaty changes suggest that this could take several years, and I believe that the likelihood of passage by all countries of the Euro area is very low. Some countries such as Germany will also require a national referendum. **Given the current political climate in Germany, I see no possibility for a majority.** The new (euroskeptic) political party ‘Alternative for Germany’ would prosper.

Allison Nathan: What should Germany be doing right now in terms of trying to promote a workable EMU?

Hans Werner Sinn: Definitely not continuing along the old path, which has already brought an enormous assumption of liability for Germany. Germany has been accused of favoring austerity, but the opposite is true. Austerity is being imposed by the markets. The countries in difficulty can’t borrow at market rates and need public intervention through the ECB or the ESM in order to bring down their interest rates. Ultimately, the still-solvent European countries are footing the bill, the largest contributor being Germany. We are talking about an overall public credit volume in the Euro area, including the extra ECB refinancing credit measured by the Target 2 balances, of €1.2 trillion, of which Germany shoulders the largest chunk. Should the euro collapse, Germany would stand to lose about €550 billion. **No country has mitigated austerity as much as Germany has, and still it gets all the blame for austerity.**

Allison Nathan: Should Germany exit the euro?

Hans Werner Sinn: Why should it? The euro as such is a worthy European integration project, and has much merit. **If Germany exits, the euro is dead,** because the whole purpose of the euro was to take away the Bundesbank’s interest-rate setting power. And if Germany exits, there would again be a dividing line between France and Germany, and the political reason for having the euro would be destroyed. So I am very strictly against such a solution.

Will the periphery survive in the euro?

Huw Pill, head of GS European economics and Themis Fiotakis of GS markets strategy discuss why peripheral countries should be able to survive in the Euro area, but the decision may not be entirely up to them

The series of crises in peripheral Euro area economies that has pushed unemployment to crippling levels and plunged the countries into deep recessions has raised the question of whether or not some of these economies will survive within the Euro area.

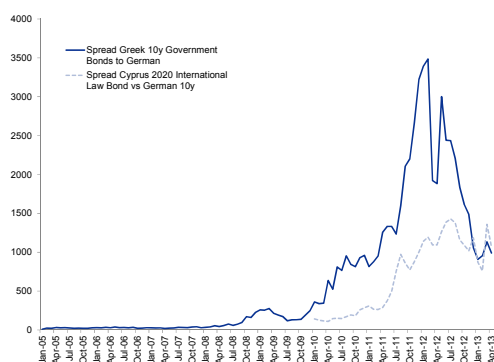
The short answer is Yes – if they continue to reform sufficiently to ensure continued financial help from the rest of Europe (until, one day, the reforms eliminate the need for the help). And while the local policy makers must adhere to rules laid out by the EMU establishment, they have a strong interest in doing so. For example, Greece and Cyprus have geopolitical reasons to be part of the EU and the EMU. And even in a narrower economic sense, they currently benefit from the subsidized loans that they are receiving from the rest of Europe. To be able to survive in the Euro area, they will continue to need that support as they undertake the reforms necessary to transform their economies and become more competitive over a lengthy period of adjustment.

These transformations will be costly in terms of economic growth and employment. But they would be required – and would be costly – whether the country was inside or outside the Euro area. That is well understood by the people in the periphery, many of which have relatively recent experience of substantial economic adjustment. Such people understand that while exit could potentially provide the benefits of a recovery of competitiveness (at least temporarily) and the opportunity to inflate away part of the debt overhang, it would most likely also bring significant costs in terms of inflation, financial disruptions, etc. So on the one hand the question is “can peripheral countries survive inside the Euro area?” But on the other hand the question is “can they survive outside?”

To some extent, **the answer to these questions will not lie solely in the hands of the country concerned.** If there is too much skepticism in the core Euro area countries that these peripheral countries will be able to adjust, their subsidized loans could be suspended, threatening them with Euro area exit. Countries that continue to look the most vulnerable are Greece and Cyprus - the market continues to demand high premiums for agreeing to hold their debt, reflecting some probability for exit.

Market still pricing some probability of Greece/Cyprus exit

Basis points



Source: Bloomberg, Haver, Goldman Sachs Global ECS Research.

Greece looks like a survivor

For Greece in particular, the prospect for Euro area exit looks very unlikely. Following some difficult and worrying dynamics, in the end a government was elected that is successfully implementing at least the bulk of the agreed reforms. When the public was faced with the choice of a party whose policy preference would have endangered Euro area participation, it is striking that eventually the electorate chose to stick with the adjustment program. The current government is likely to remain in power and continue with the implementation of the program at least for the next 12 months. By then, most of the adjustment effort will likely have been exerted and the risks for deeper political crises leading fringe parties to power will likely have declined. The restructuring in privately and officially held debt that took place in 2011 and 2012 has reduced default and contagion risks significantly and adherence to the program is likely to bring about further easing in program goals and lending terms, should economic conditions require.

The key missing element for markets to price Greek euro-exit risk out entirely will be the return of growth. Labor market reforms have brought about significant reductions in wage costs for companies. And financing conditions are starting to ease, reducing the (still very high) cost of funding. Higher margins for companies and suppressed domestic demand should create growth in the export sector. But the small size of the export sector relative to GDP means that it will likely take a while for this export sector growth to help produce meaningful declines in unemployment, which is currently at very high levels (near 27%). Overall, our base case is that Greece survives within the Euro area, but that requires the ability of society to endure painful reform even in the context of very high and persistent unemployment.

Cyprus not yet out of the woods

For Cyprus things are trickier. The implications of the agreement made in March to address Cypriot bank recapitalization needs by bailing-in large depositors are still unfolding. And their detrimental impact on the stability of the local banking system has left the local economy significantly scarred. The banking system will continue to function on a limited level for some time. And capital controls are unlikely to be lifted in the near-to-medium term as banks are expected to come under significant deposit flight pressure. The collapse of the oversized financial sector of the island and all the supporting industries (legal, consulting, real estate development, restaurants, transport) implies a shrinkage in GDP that is hard to project, but could end up being much greater than current official estimates. Therefore, **both the funding assumptions and the sustainability assumptions of Cyprus' assistance program could prove to be very optimistic, implying further troubles ahead.** Thus, while still the less likely path, a non-trivial risk of exit remains. That being said, our base case for Cyprus is that they too remain in the Euro area. But that will ultimately depend on whether the society can live with a painful adjustment and to what lengths Euro area governments are willing to go to fund it.

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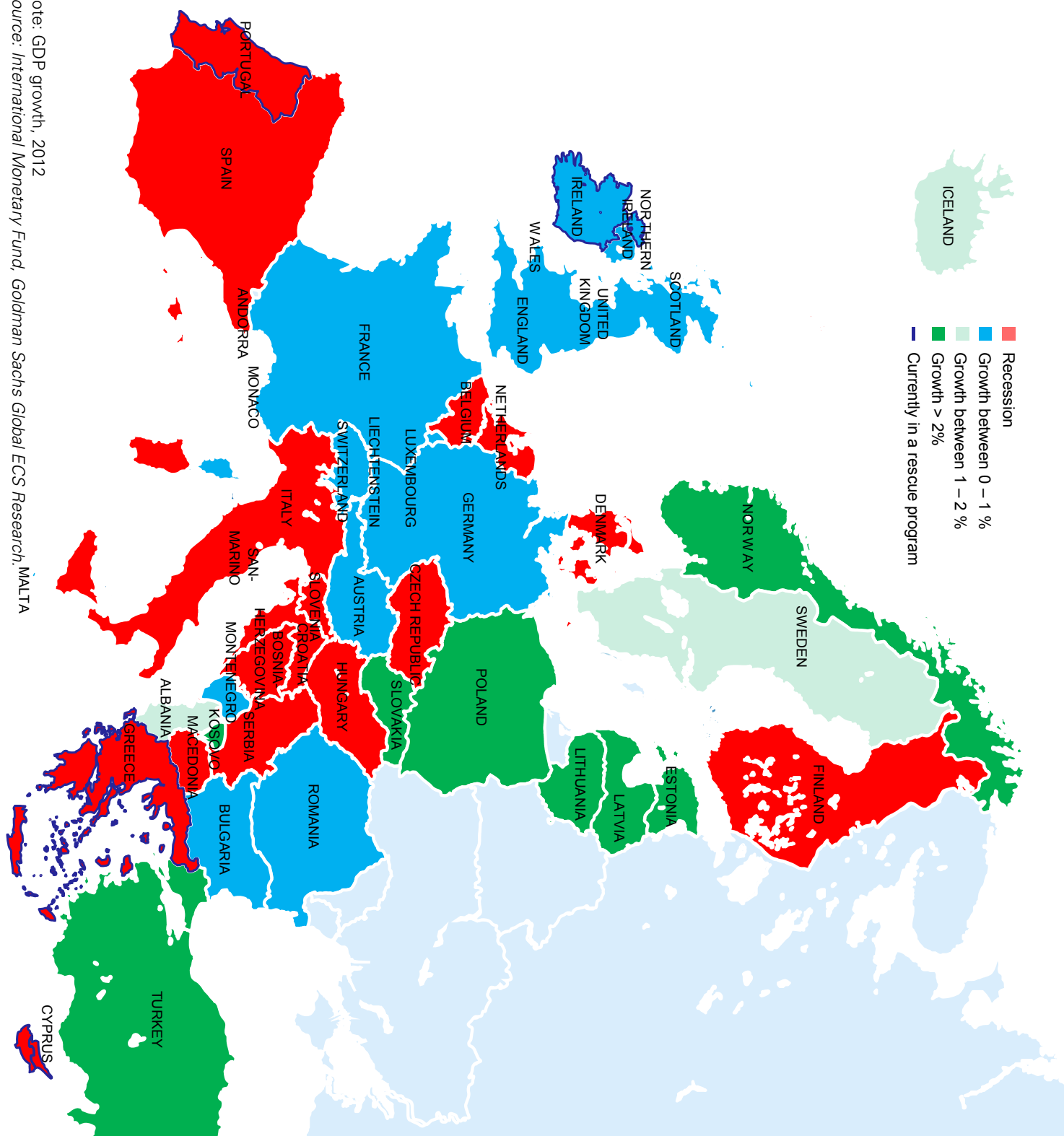
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Which (few) EU economies are growing?



Note: GDP growth, 2012

Source: International Monetary Fund, Goldman Sachs Global ECS Research.

UK in or out?

Kevin Daly of the GS European economics team addresses the high costs of potential UK exit from the EU (for the UK and the EU), but also why exit still seems unlikely

The UK public has always been relatively lukewarm about European integration and the Euro area crisis has resulted in increased opposition to the EU. So much so that the UK is pursuing a "renegotiation" of its relationship with the rest of the EU that would be enshrined in changes to the EU treaty, and **UK Prime Minister David Cameron pledged earlier this year to hold an in/out referendum on the UK's EU membership.** The British view is that need for institutional reform in the Euro area (and the associated potential treaty change) creates a window of opportunity to protect UK interests in the single market as the Euro area integrates more closely, especially in areas of particular interest for the UK (notably financial services).

Assuming a successful renegotiation and associated progress in the reform of EU institutions and policies, the political leadership pledged to campaign for the UK's continued EU membership, which they believe would be favorable to the UK's national economic interests. **But the rest of Europe, which is more consumed with making the Euro area workable than addressing British sensitivities, may not easily acquiesce to British demands,** leaving the UK's future membership in the EU – at least over the longer term – in question.

A UK exit from the EU would be costly...

Exiting the EU would come with a significant economic cost for the UK, in our view. The UK economy is highly integrated with the EU – **trade with other EU countries amounts to 16% of UK GDP** and the UK financial system is closely integrated with continental Europe. Those who oppose EU membership argue that Switzerland and Norway have continued to do well, despite remaining outside of the EU. But, given the size and importance of the UK economy, **it is unlikely that the UK could negotiate the same access to the EU single market that Switzerland and Norway have achieved.** In particular, the UK's ability to conduct business in financial services across the European Union is likely to be severely compromised by a departure from the EU.

In addition to being costly for the UK, a UK departure from the EU would also be costly for the EU. **The UK is the Euro area's largest trading partner, accounting for 4% of Euro area GDP.** Moreover, the UK has played an important political role in the EU: it was the leading force behind the formation of the EU single market and, more generally, it has acted as an economically liberal counterweight to the more state-centric approach adopted by France.

In this sense, we believe that **a UK exit from the EU would represent a 'loss/loss' scenario for both the UK and the EU.** However, it is likely that the loss would be greater for the UK than for the EU.

...but unlikely

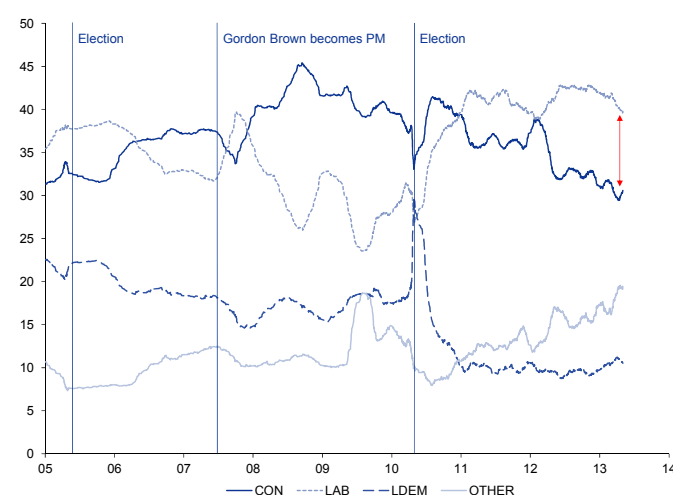
Despite the commitment by David Cameron to use the opportunity presented by any treaty renegotiation related to Euro area reform

to forge a new relationship with the EU and to hold a referendum on EU membership in five years' time, **it is far from clear that such an in/out referendum will take place.** First, it is not clear that the EU treaty would need to be changed to implement the changes envisaged by the Euro area countries. Second, in order for Mr. Cameron to be in a position to implement his proposals, his Conservative Party must first win an outright majority in the next general election (which is scheduled for May 2015). Opinion polls currently suggest this is unlikely.

According to these polls, 31% of the electorate intends to vote for the Conservatives, 9 percentage points less than Labour (40%). Support for the Liberal Democrats stands at 11%. The gap between Labour and the Conservatives has grown in the past 18 months, partly because the Conservatives lost support of the UK Independence Party (UKIP) (whose support currently stands at 10%). In order to win an overall majority in parliament, most estimates suggest that the Conservatives would need to defeat Labour in the popular vote by a margin of 8-10 percentage points (implying the need for a 17-19 percentage point swing in the Conservatives favor from current poll standings). At this stage, this doesn't appear likely.

A growing gap in favor of Labor

Rolling average of opinion poll readings of party support, %



Source: YouGov, ICM, Mori, ComRes, TNS, Populus, Opinionum.

Moreover, even if an in/out referendum is held, **opposition to the EU could prove ephemeral once the public is presented with the economic and political costs of departure.** While opinion polls suggest that UK public support for the EU has generally been low, those polls also point to a sharp swing in favor of the EU when there is a significant focus in the media on the cost and benefits of membership. Thus, while a UK exit from the EU would be costly, we still view this as unlikely over the medium term (five-year horizon). Over the longer-term, should a better functioning Euro area become the dominant organizational structure in Europe as we expect, the likelihood that the UK will move farther away from the rest of Europe grows.

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Snapshot of our views

Implications of the Ins and Outs of the EU/EMU

FX Thomas Stolper & Team	- Arguably markets have lowered their guard around “exit risks” as evident by the risk premia compression across peripheral bond markets. But a level of caution persists and this weighs on the levels of the EUR. As per our main view, the ongoing reduction in premia will likely support a higher level for the euro. - For countries undergoing fiscal and structural adjustment, the absence of nominal exchange rate flexibility implies that the necessary gains in competitiveness will come via relative price declines vis a vis core Europe. - An exit from the Euro area would accommodate the nominal exchange rate adjustment and reduce the need for policies that compress prices locally for distressed countries. But it would come at a large cost: it would endanger financial stability. The disincentive is strong enough for us to argue that the most likely outcome is for countries to stay in the Euro area (if they are given the choice). Should a small country choose to exit, the new currency would likely depreciate significantly at first. The impact on the EUR vs. the USD should initially be negative due to the effects of risk aversion on the system. But in the long run, it is not clear whether such an exit would affect EUR fundamentals, particularly if there are no subsequent exits from other, more systemically important countries. - For countries choosing to opt into the euro in the future, the exchange rate would depend on the policy pursuits of local authorities and the FX level considered “fair” in terms of safeguarding the country’s competitiveness.
Rates Francesco Garzarelli & Team	- US Treasury yields are well below our measures of macro “fair value” and we expect 10-year US Treasury yields to gradually realign with their macro underpinnings. - We forecast 10-year UST yields at 2.5% by year-end and at 3.75% in 2016, the end of our forecast horizon. - Our forecasts assume that, although at a very slow pace, the Euro area will continue to build up institutions that will allow the currency area to develop into a financial, fiscal and, eventually, political union. We do not expect any country to leave the Euro area during our forecast horizon and assume that policy makers will be able to keep concerns around the survival of the EMU in check. Should this not be the case and concerns around the single currency re-emerge, UST, and yields of other core bonds would likely fall as capital would flow into ‘safe haven’ fixed income markets.
Credit Charlie Himmelberg & Team	- In our view, the European sovereign crisis has evolved from “Lehman” risk to “Japan” risk. By this we mean the crisis has evolved from the risk of a “sudden stop” in sovereign funding (and exit) to the reality of a double-dip recession followed by a prolonged period of slow, sub-potential GDP growth. - The ECB’s OMT was key to this transition, and because backstop funding is now available to sovereigns, we no longer think credit premia need to embed as large a systemic risk premia. We view this as having been the key enabler of the “search for yield”. - This does not mean that we think corporate credit risk in Europe has fallen to US levels. On the contrary, we think credit spreads under-compensate for the level of credit risk in Europe vs. the US. This is likely because the “search for yield” has fewer attractive options in Europe than in the US. - Put differently, we think the “term structure” of European corporate risk ought to be more steeply sloped for European than for US exposures. This is because we expect the cumulative effects of recession followed by slow growth will further erode relative credit quality from current levels, and this should be reflected in relatively higher credit spreads on longer-maturity credits in Europe. - We therefore maintain our relative value preference for US over European exposures.
Equity David Kostin (US) Kathy Matsui (Japan) Tim Moe (Asia ex-Japan) Peter Oppenheimer (Europe) Helen Zhu (China) & Teams	- The impact of the European sovereign situation on equity markets has so far been most visible in the relative performance of the equity markets in the European periphery vs. the equity markets in the European core and on a sector basis in the European Banks and Insurance space. - Since last summer the rally in the areas most affected by the crisis has been largely driven by a decline in the risk premium that markets had built into prices to reflect concerns about a disorderly break-up. We think that this risk premium compression on the back of lower break-up concerns has largely run its course, and we believe that performance increasingly will be driven by fundamentals in terms of economic growth and its consequences for earnings. On this basis, we prefer companies in Europe with international sales exposure over those which are domestically exposed. If concerns about a disorderly break-up re-emerge, we would expect the same areas of the market to be most affected again. However, if the composition of the Euro area was only to change a few years from now in the context of stronger Euro area institutions that could limit contagion, the impact on equity markets would likely be much more muted.
Commodity Jeff Currie & Team	- The European sovereign situation has contributed to weak commodity demand as well as a sharp drop in inventories as firms continue to de-lever. Although the destocking cycle has likely ended, continued weak demand has contributed to the slow global growth environment that is currently weighing on commodity prices. A disorderly break-up of the Euro area would exacerbate this regional demand weakness as well as likely impact the financing of commodity operations, which could further reduce the incentive to hold inventories. This could magnify the decline in prices relative to other asset classes, as occurred in 2009 and briefly in 2011.

Why join?

Magdalena Polan of our CEMEEA economics team discusses why countries are still lining up to join the EU and even the Euro area

Despite the Euro area's woes, countries are lining up to join both the EU and adopt the euro. Croatia will become the EU's 28th member on July 1, Serbia has made significant progress on its way to membership, and Lithuania and Latvia are getting ready to introduce the euro (and Estonia did so just recently). But with the Union fighting fires on many fronts and in the throes of a tricky process to re-define itself, what is the allure of joining the club?

EU membership is still a no-brainer

The rationale for joining the EU itself is straightforward, in our view. The geopolitical incentives for being part of the EU (and ultimately the Euro area) in particular should not be underestimated. **For countries in Northeastern Europe (as well as Greece, Cyprus and others), EU membership is a large part of solidifying the current desired orientation towards Western Europe, and away from the Soviet sphere.** It is therefore a coveted status and a key signal of leaving the past behind and moving forward as a democracy and a market economy. Membership would also give these countries a direct voice in the decisions of the EU, which in most cases is already the most important political and economic partner for them, rather than having to react and adjust to these decisions. **The transfer of some sovereign power is offset by the greater role on the EU-wide stage.**

On the economic level, the removal of trade and financial barriers, the harmonization of laws, and free flow of capital mainly supports trade, and is especially helpful in sectors where proofs of safety and quality, such as food production, are important. But it also helps attract investments, not only from large multinationals (which established a presence in the 'new' member states well before they joined the EU) but also from smaller corporates, for which foreign expansion beyond the EU would be too costly and difficult.

Finally, EU membership brings significant monetary gain for countries where income is below the EU average, in the form of various structural and cohesion capital transfers. These can be used to develop both hard capital (like infrastructure) and soft capital (training, supporting innovation and entrepreneurship), laying foundations for stronger growth in the medium and long term. This support becomes an important source of growth later on when, inevitably, marginal gains from the transition process start to fall and wage differentials narrow, eroding competitiveness.

Euro adoption is thornier, but less so for smaller nations

The cost-benefit analysis becomes much more complicated when it comes to joining the Euro area, but less so for smaller countries. **A number of smaller countries already peg their currency to the euro**, so abandoning their national currencies does not change much. Of course, a peg can always be abandoned while exiting the Euro area is a much more complicated process. But joining the Euro area removes the risk of de-pegging, which reduces the risk premium associated with the country. Also, by having a hard peg to the euro in some sense they are already suffering the costs in terms of macroeconomic adjustments that being part of the single currency entails. But they are not getting the benefit in terms of access to ECB facilities and ability to participate in ECB and wider Euro area decisions. Joining would remedy this disconnect.

Larger countries face a greater challenge

The discussion and cost-benefit analysis becomes truly multidimensional for the larger countries. This mostly applies to Poland, the largest among new member states, without the freedom to opt-out from the EMU (when entering the EU, new member states committed to adopting the euro in the future). From an economic perspective, Poland prefers to wait before joining. The benefits appear small for now. The removal of FX risk and lower transaction costs associated with a common currency would always help, but they do not appear to be a significant constraint to Poland's trade with the Euro area. The capital market is liberalized in any case, and Poland receives substantial capital inflows. Although Foreign Direct Investment (FDI) inflows declined after 2008, this decline appeared to have more to do with the uncertain outlook for the European and global economy, rather than the fact that Poland had a floating exchange rate. In fact, rapid depreciation after the 2008 crisis may have attracted more inflows.

And, importantly, the floating currency proved to be an important shock absorber, helping boost Polish exports on a number of occasions after 2008 when uncertainty over the future of the Euro area weakened the zloty. **Going through the crisis relatively unscathed, without the protective umbrella of the euro and the ECB, demonstrated that the ability to respond to shocks mattered more than participation in the monetary union.** The potential cost of spillovers from renewed troubles in the Euro area has also made staying outside the EMU a more attractive option until the EMU is a "safe" club to join.

Euro important... even outside of the Euro area

Country	Dates of actual or planned Euro adoption	FX regime
Euro area joiners since the GFC		
Slovakia	Jan-09	€
Estonia	Jan-11	€
EU without opt-out option		
Latvia	Jan-14	Peg to Euro (Lats)
Lithuania	Jan-14	Peg to Euro (Litas)
Romania	Jan-18	Free Floating (Leu)
Bulgaria	Not specified	Currency board (Lev)
Czech Republic	Not specified	Free Floating (Koruna)
Hungary	Not specified	Free Floating (Forint)
Poland	Not specified	Free Floating (Zloty)
Non-EU Euro users or peggers		
Kosovo		YUM and Euro
Montenegro		YUM and Euro
Bosnia and Herzegovina		Currency board

Source: Goldman Sachs Global ECS Research.

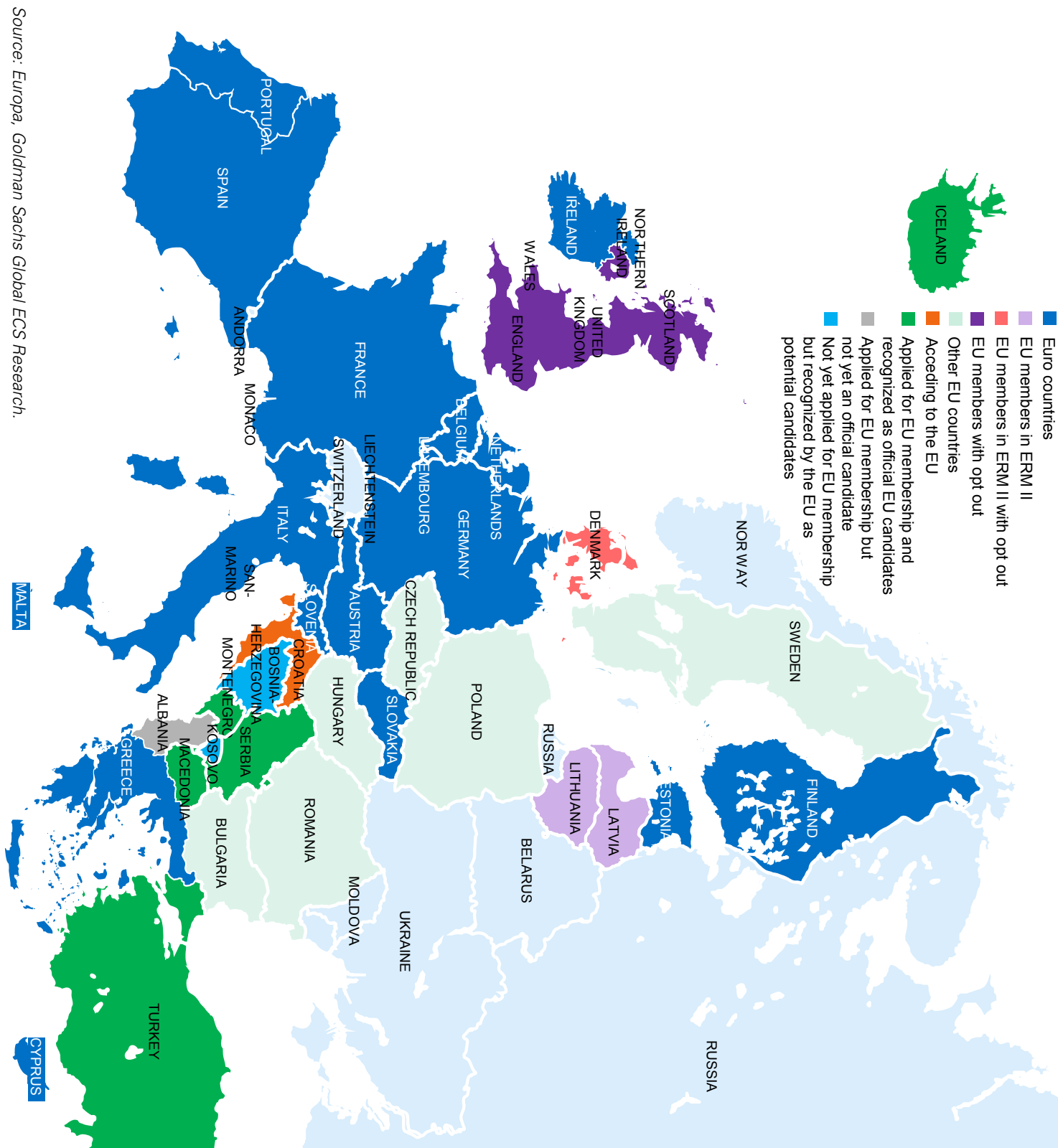
But while countries like Poland can afford to wait, the political considerations suggest otherwise. The Euro area is being re-defined and with that, the weight and center of EU discussion has moved towards the Euro area. Countries outside the Euro area are left out, while still expecting to join a club whose rules are being rewritten in the meantime. **And with the 'new' Euro area likely becoming the core of the 'new' EU, staying outside brings the risk of being relegated to a second-tier Europe.** For a country of its size and EU-wide ambitions, Poland does not want to be left out. For now, it seems that the risks and costs associated with joining soon are still too high. But at some stage the political incentives may overwhelm the economic ones. That will be up to the government, and, importantly, the public to decide.

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EU/Euro area, present and future

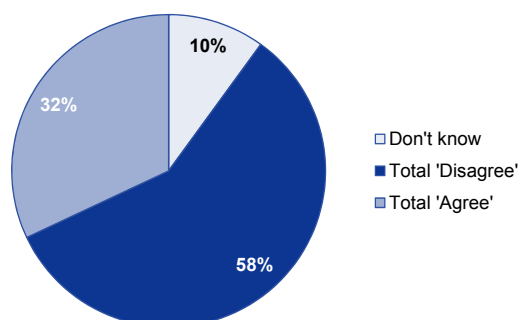


EU/EMU ins and outs in pics

A special thanks to the GS European economics team for most of these pics.

Survey says... still better off inside the EU than out

%

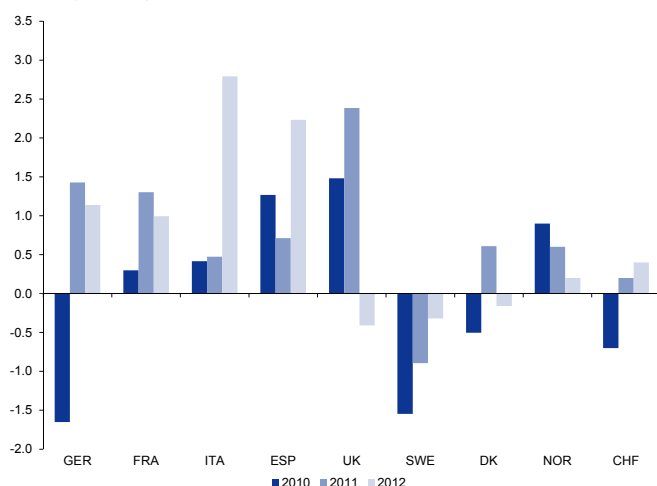


Responses to the question: please tell me to what extent you agree or disagree with the following statement: (OUR COUNTRY) could better face the future outside the EU.

Source: European Commission, Standard Eurobarometer 78, Autumn 2012.

Austerity all around...in the periphery

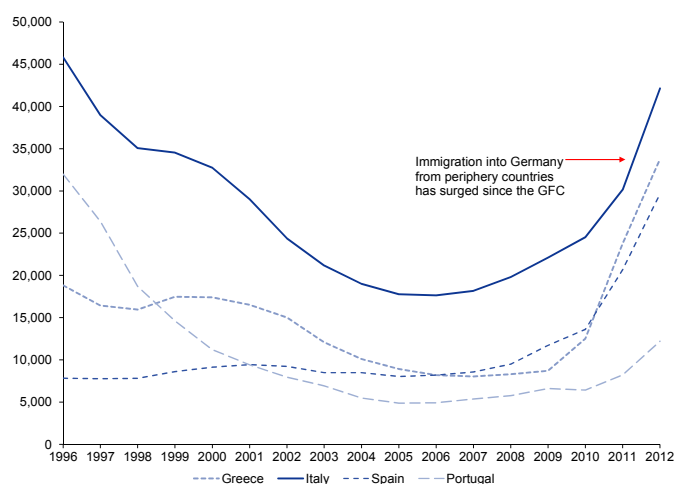
Fiscal tightening*, % of GDP



*Calculated as the annual change in the cyclically adjusted primary government budget balance (excl. one-off measures) in % of GDP
Source: EU Commission, OECD.

Another way to exit...move!

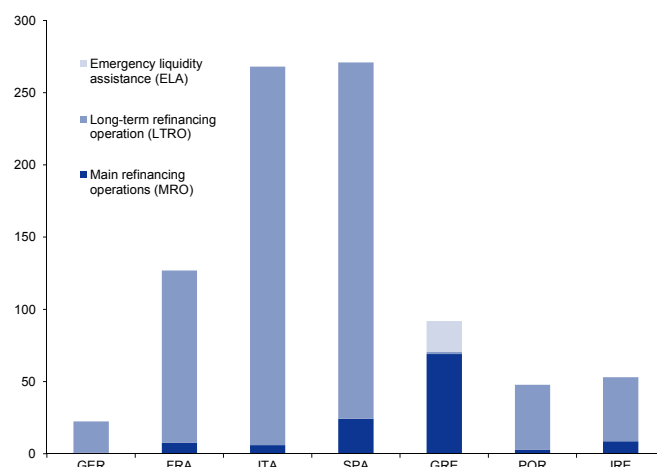
Immigration into Germany from each country, no. of people p.a.



Source: Destatis, Goldman Sachs Global ECS Research.

ECB still showing lots of love to peripheral banks

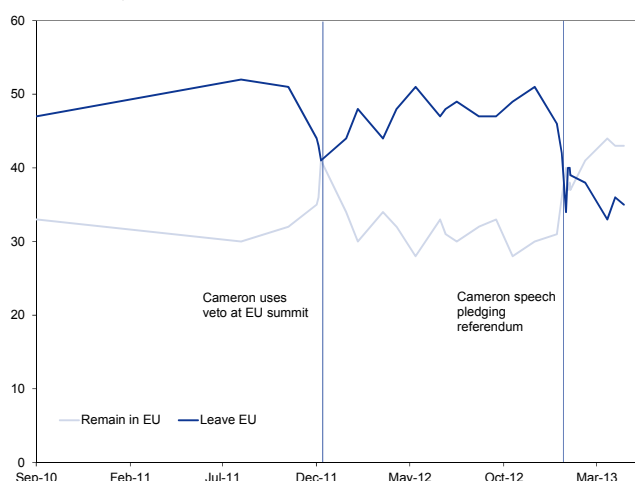
€ bn (March 2013 data)



Source: National Central Banks, Goldman Sachs Global ECS Research.

The British want to leave the EU...sometimes

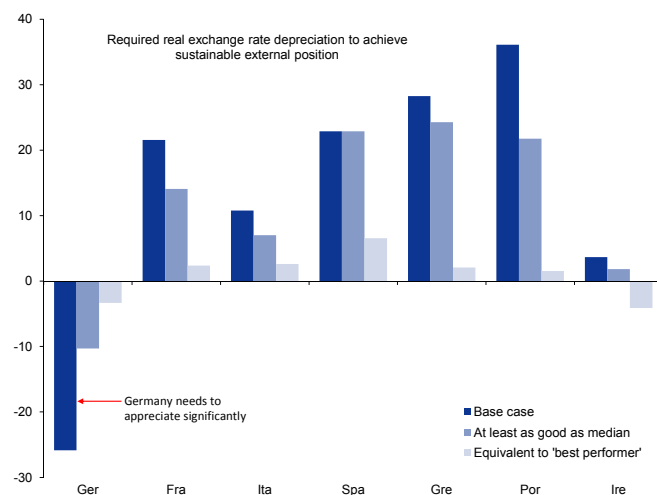
How would you (British citizen) vote in a referendum on EU?



Source: Yougov.

A long depreciation road ahead

%



Source: Eurostat, Goldman Sachs Global ECS Research.

Snapshot of our key forecasts

	GDP Growth (% yoy)				FX				Equity				Rates (% eop)				Revision Notes
	2013		2014		3-mth		12-mth		3-mth		12-mth		Policy		10-yr		
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	2013	2014	2013	2014	
Global	3.2	3.3	4.1	3.9	-	-	-	-	-	-	-	-	-	-	-	-	
					EUR/\$				SP500								As of May 16, we now expect a slightly stronger EUR/\$ in the near term owing to the rally in US Treasuries and the weak patch of global data.
US	2.0	2.1	2.9	2.7	1.34	1.29	1.40	1.26	1550	-	1650	-	0.13	0.13	2.5	3.0	
					EUR/\$				Eurostoxx 50								On April 25, we revised down our 2013 growth forecast owing mainly to weaker-than-expected growth in 1H13, especially in Germany and Italy. We reduced our policy rate forecast to reflect the ECB rate cut on May 2. As of May 16, we now expect a slightly stronger EUR/\$ in the near term owing to the rally in US Treasuries and the weak patch of global data.
EURO AREA	-0.7	-0.4	0.8	0.9	1.34	1.29	1.40	1.26	2750	-	3000	-	0.50	0.50	-	-	
					EUR/\$				DAX								On April 25, we revised down our 2013 growth forecast as the rebound at the beginning of the year after the decline in Q4 last year has been less forceful than we initially expected. As of May 16, we now expect a slightly stronger EUR/\$ in the near term owing to the rally in US Treasuries and the weak patch of global data.
GERMANY	0.1	0.7	1.8	1.7	1.34	1.29	1.40	1.26	-	-	-	-	-	-	1.8	2.0	
					\$ /CNY				HSCEI								As of May 16, We now expect the PBoC's \$/CNY fix to remain stable at around 6.20 in 3 and 6 months on the back of slower activity and the recent SAFE measures, which were designed to reduce speculative appreciation pressure. We expect the fix to be 6.18 in 12 months.
CHINA	7.8	8.2	8.4	8.0	6.20	6.16	6.18	6.10	-	-	-	-	6.00	6.50	-	-	
					\$ /BRL				BOVESPA								As of May 16, a patch of better US data and a recent rapid rise in US yields has pushed \$/JPY decisively above 102, precipitating a slight tweak in our forecast towards a weaker Yen.
BRAZIL	3.3	3.1	4.4	3.7	1.95	2.01	1.95	2.04	-	-	-	-	8.50	8.50	-	-	
					\$ /JPY				TOPIX								On April 23, we reduced our near-term Brent forecast to \$100/bbl from \$110/bbl largely on expectations of weaker Chinese demand.
JAPAN	1.4	1.3	1.7	1.3	105	101	110	105	1180	-	1350	-	0.10	0.10	0.8	1.0	
Commodities	Brent crude oil (\$/bbl)				Copper (\$/mt)				Gold (\$/toz)				Corn (\$/bu)				Revision Notes
	3-mth		12-mth		3-mth		12-mth		3-mth		12-mth		3-mth		12-mth		
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	
	100	106	105	107	-	7500	-	7000	7776	1530	1604	1390	1615	6.50	-	5.25	-

Note: Recent revisions marked in red. GDP consensus is Consensus Economics, all other consensus is Reuters, commodity 12-mo consensus is Reuters for 2014 average.
Source: Goldman Sachs Global ECS Research.

Glossary of GS proprietary indices

Current Activity Indicator (CAI)

Measures the growth signal in the major high-frequency activity indicators for the economy. Gross Domestic Product (GDP) is a useful but imperfect guide to current activity. In most countries, GDP is only available quarterly, is released with a substantial delay, and initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs are alternative summary measures of economic activity that attempt to overcome some of these drawbacks. We currently calculate CAIs for the following countries: USA, Euro area, UK, Norway, Sweden, China, Japan, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Australia and New Zealand.

Financial Conditions Index (FCI)

Financial conditions are important because shifts in monetary policy do not tell the whole story. Our FCIs attempt to measure the direct and indirect effects of monetary policy on economic activity. We feel they provide a better gauge of the overall financial climate because they include variables that directly affect spending on domestically produced goods and services. The index includes four variables: real 3-month interest rates, real long-term interest rates, real trade-weighted value of the exchange rate and equity market capitalization to GDP.

Global Leading Indicator (GLI)

Our GLIs provide a more timely reading on the state of the global industrial cycle than the existing alternatives, and in a way that is largely independent of market variables. Global cyclical swings are important to a huge range of asset classes; as a result, we have come to rely on this consistent leading measure of the global cycle. Over the past few years, our GLI has provided early signals on turning points in the global cycle on a number of occasions and has helped confirm or deny the direction in which markets were heading. Our GLI currently includes the following components: Consumer Confidence aggregate, Japan IP inventory/sales ratio, Korea exports, S&P GS Industrial Metals Index, US Initial jobless claims, Belgian and Netherlands manufacturing surveys, Global PMI, GS Australian and Canadian dollar trade weighted index aggregate, Global new orders less inventories, Baltic Dry Index.

Goldman Sachs Analyst Index (GSAI)

Our US GSAI is based on a monthly survey of Goldman Sachs equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on their responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

Macro-data Assessment Platform (MAP)

Our MAP scores facilitate rapid interpretation of new data releases. In essence, MAP combines into one simple measure the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. We put a sign on the degree of surprise, so that an underperformance will be characterized with a negative number and an outperformance with a positive number. We rank each of these two components on a scale from 0 to 5, and the MAP score will be the product of the two, i.e., from -25 to +25. The idea is that when data are released, the assessment we make will include a MAP score of, for example, +20 (5;+4)—which would indicate that the data has a very high correlation to GDP (the '5') and that it came out well above consensus expectations (the '+4')—for a total MAP value of '+20.' We currently employ MAP for US, EMEA and Asia data releases.



Disclosure Appendix

Reg AC

We, Allison Nathan, Silvia Ardagna, Kevin Daly, Themis Fiotakis, Huw Pill and Magdalena Polan hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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